1994

Credit union industry developments - 1994; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Credit Union Industry Developments—1994

Complement to AICPA Audit and Accounting Guide *Audits of Credit Unions*

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of credit unions with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Industry and Economic Developments

Throughout the first three quarters of 1994, the United States economy as a whole continued its steady recovery from several years of recession. Most analysts have attributed the recovery in large part to a low rate of inflation and growing consumer confidence. The efforts of the Federal Reserve System to keep inflation at bay by slowly raising interest rates had only a moderate effect on the nation's credit union system, as loan and share growth continued at a steady pace.

Credit unions, along with a number of other business enterprises, sought new ways to control costs during the year. In order to keep costs down, many credit unions have made arrangements to share branch offices with other credit unions and depository institutions. These and other industry and economic developments are discussed in the following sections.

Rising Interest Rates

Despite the recent rise in interest rates, loan demand at credit unions remains strong, outpacing even the rapid growth in members' share and savings accounts. This is attributable largely to increasing consumer confidence in the improving economy. Surprisingly, the higher interest rates have not resulted in an increase in the interest-rate spreads, that is, the difference between the rates credit unions charge on loans and the rates they pay to attract funds. Generally, those spreads have declined because many higher rate, long-term assets matured and were replaced with assets yielding lower rates. In addition, the recent rise in interest rates enhances interest-rate risk, particularly for credit unions that invest heavily in long-term, fixed-rate assets. If interest rates continue to rise, credit unions will likely be forced to pay higher rates on members' share and savings accounts, which would ultimately narrow the spreads if those credit unions are heavily invested in those long-term, fixed-rate assets. As a result, many credit unions are managing their mix of financial assets and liabilities to limit exposure to the potential negative effect of upward movements in interest rates.

Although the improving economy has increased overall loan demand, climbing interest rates have curbed mortgage loan demand

and rising interest rates could eventually affect other types of lending. Credit unions may attempt to expand their loan portfolios by increasing the risk they are willing to accept. For example, a credit union that has traditionally made only consumer loans may adopt more lenient lending policies that may include business or real estate lending or indirect lending or leasing. In planning their audits, auditors should consider whether the credit quality of borrowers in those new lines of business is subject to the same underwriting standards already employed by the credit unions. Also, auditors should consider how changes in the credit unions' business in response to industry or economic pressures may affect audit risk. Certain audit risks are discussed in more detail in the "Audit Issues" section of this Audit Risk Alert.

Sharing of Branch Offices

Economic pressures are also forcing credit unions to look for ways to become more efficient and reduce their operating expenses. A number of credit unions are achieving those goals through shared-branch networks. Under shared-branch arrangements, credit unions are able to minimize the cost of doing business as well as provide their members with multiple locations by sharing branch facilities and staff with other, unrelated credit unions.

As they plan and conduct their audits, auditors should be aware of the audit risks that may arise from shared-branch arrangements. See the "Audit Issues" section of this Audit Risk Alert for a further discussion of the audit risks related to shared branches.

Regulatory Developments

National Credit Union Administration Initiatives

Access to Supervisory Committee Working Papers by Authorized Employees. In 1993, the National Credit Union Administration (NCUA) Board issued final rules providing for regulatory review of working papers that support supervisory committee audits (see *Federal Register,* vol. 58, no. 140, July 23, 1993). The rules state the following:

> The supervisory committee and/or its independent auditor shall be responsible for the preparation and the maintenance of original working papers to support each supervisory committee audit. Such original working papers shall be made available at the credit union offices or within a reasonable proximity by the supervisory committee and its independent auditors for review by any authorized employee of NCUA. If the credit union supervisory committee fails to do so, NCUA can reject the supervisory committee audit as inadequate in meeting the requirements.

Auditors who have been requested to provide such access should refer to Interpretation No. 1 of Statement on Auditing Standards (SAS) No. 41, *Working Papers,* titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards,* vol. 1, AU sec. 9339). The Interpretation provides auditors with guidance on—

1. Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
2. Making appropriate arrangements with the regulator for the review.
3. Maintaining control over the original working papers.
4. Considering submitting to the regulator a letter clarifying that an audit in accordance with generally accepted auditing standards (GAAS) is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation.

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

The complete text of this Interpretation was published in the July 1994 issue of the *Journal of Accountancy* ("Official Releases").

Final Rule on Investment and Deposit Activities. On June 30, 1993, the NCUA issued a rule revising its high-risk test for collateralized mortgage obligations (CMOs), including real estate mortgage investment conduits (REMICs). The new test includes an average-life test, an average-life sensitivity test, and a price test (*Federal Register,* vol. 58, no. 124, June 30, 1993). The NCUA may seek the early disposition of investments that are believed to constitute a significant threat to a credit union's continued sound operation. Such forced dispositions can negatively affect a credit union's liquidity, earnings, and capital positions.

Because such restrictions and requirements can affect the classification and valuation of assets, auditors should assess the risk that any violations of such rules and regulations might result in a material misstatement of a credit union's financial statements, in accordance with SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317).

See the "Accounting Developments" section of this Audit Risk Alert for a further discussion of how the revised rules may affect the classification and valuation of certain debt and equity investments in a credit union's financial statements in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text,* vol. 1, sec. I80).

Truth-in-Savings Disclosures. In 1993, the NCUA issued a final rule (the Rule) on Truth-in-Savings Regulation Part 707 to implement the Truth-in-Savings Act of 1992. Credit unions have until January 1, 1995, to comply with the Rule, but earlier compliance is encouraged.

The Rule may substantially change the way certain credit unions calculate the interest they pay on deposit accounts. It limits credit unions to calculating interest based on the daily balance or the average daily balance in a deposit account. Currently, many credit unions use either the *rollback* or *par value* method to calculate interest on deposits. Under the rollback method, interest is calculated based on the lowest continuous balance after a specified date. Using the par value method, credit unions pay interest on par value increments, such as $5 shares, rather than on actual account balances.

For many credit unions that currently use either of those methods to calculate interest, a change to comply with the Rule may significantly increase the interest they pay on deposit accounts. Because violation of the Rule could cause a material misstatement of a credit union's financial statements, auditors should test whether interest is calculated according to its provisions. See SAS No. 54 for a further discussion of the auditor's responsibility regarding illegal acts that can have a direct and material effect on the determination of financial statement amounts.

Before a credit union opens deposit accounts, it must disclose to members or potential members the fees, interest rates (referred to as dividends in credit unions), and other terms pertaining to those accounts. In addition, the Rule requires credit unions to provide depositors with periodic statements that contain account information about fees imposed, interest earned, and the annual yield.

Many credit unions may need to obtain computer software or hardware to comply with the Rule. Some also may incur additional costs related to training, printing, and other materials. Auditors should also be aware that credit unions are limited by regulatory authorities to a maximum investment in property and equipment, including lease payments, which may limit their ability to acquire the equipment necessary to comply with the Rule. The NCUA staff has informed the AICPA staff that they will consider, on a case-by-case basis, granting a *fixed-asset waiver* for credit unions that must make major purchases, such as computer systems, to aid in compliance.

Student Lending. The Higher Education Act of 1965 (HEA) was amended in 1992 to require compliance audits of lenders who participate in Federal Family Education Loan (FFEL) programs. Many credit unions are subject to the requirements because they participate as lenders in these FFEL programs, which include the Federal Stafford Loan Program (formerly the Guaranteed Student Loan Program), the Federal Supplemental Loans for Students Program, the Federal PLUS Program, and the Federal Consolidation Loan Program. The HEA requires that the engagements be performed in accordance with the U.S. General Accounting Office's (GAO's) *Government Auditing Standards,* which include general standards for an external quality control review and for continuing education requirements.

In December 1992, the U.S. Department of Education (ED) issued implementing regulations, specifying that procedures for conducting the audits would be disseminated in a guide developed by the ED's Office of the Inspector General (OIG) (*Federal Register* [December 18, 1992]). The regulations made the reporting requirement effective for fiscal years beginning after July 23, 1992; however, no guide has been issued. As this alert was being completed, the OIG was expecting to issue a guide in late 1994.

As currently drafted, the guide would require an examination of management's assertion of compliance with certain requirements for preparation of the *Lender's Interest and Special Request and Reports* (ED Form 799), performed (in part) in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards,* vol. 1, AT sec. 500). If finalized as drafted, the guide would allow lenders with fiscal years ending in August through December the option of filing (1) separate reports for their fiscal years 1993 and 1994 or (2) a single report covering both fiscal years 1993 and 1994. If separate reports are filed, the 1993 report would be due within six months after issuance of the guide, and the 1994 report would be due within six months after issuance of the guide or within six months after the end of the fiscal year, whichever is later. If a single report is filed, it would be due within six months after the end of the two-year period. Lenders with fiscal years ending in any of the months of January through July would be required to file the initial 1994 report within six months after issuance of the guide. Subsequent reports would be required to be filed on an annual basis within six months after the close of the lender's fiscal year-end.

Auditors may wish to discuss the reporting requirements with clients and should be alert to the issuance of a final guide.

U.S. Department of Education. In June 1994, the U.S. Department of Education issued a final rule that establishes exceptional performance standards for lenders, servicers, or guaranty agencies participating in the FFEL program. The Department of Education requires that lenders, servicers, or guaranty agencies that seek an exceptional performance designation—thus entitling them to certain economic benefits—submit a report of a compliance audit that yields a compliance performance rating of 97 percent or higher of all due diligence requirements. The ED's OIG will develop guidance for implementing this final rule. The AICPA expects that the implementation guidance will require that the compliance audits be performed as attestation engagements. The rule becomes effective July 1, 1995, the date that the Department of Education can first designate exceptional performer status to an institution.

Audit Issues and Developments

Audit Issues

Concentrations of Credit Risk. Because of their common bond requirement, credit unions frequently have high concentrations of credit risk, more so than other financial institutions. Auditors should be aware that even though the general economy is improving, a number of industries and areas of the country are recovering very slowly, if at all. Auditors should be alert to concentrations that place credit unions at a high level of risk of loss. In addition, auditors should consider whether adequate disclosure of those concentrations has been made in accordance with FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25).

High-Risk Investments. In recent years, a number of credit union investment managers have continued to pursue a strategy for better returns on investment by placing an increasing portion of their assets in innovative financial instruments that often are very complex. A number of those investments may involve a substantial risk of loss. Users of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors also should be familiar with such instruments and the associated audit ramifications.

Regulation permits credit unions to invest in certain types of derivatives (see page 12) and on-balance-sheet investments that may sometimes be considered high risk. Such on-balance-sheet investments include the following:

- Mortgage-backed securities (MBS) issued or fully guaranteed by agencies of the United States Government
- Mortgage-related derivatives such as stripped mortgage-backed securities and collateralized mortgage obligations, if they are acquired solely to reduce interest-rate risk
- Asset-backed security residuals, except asset-backed residuals supported by installment loans, leases, or revolving lines of credit (Auditors should be aware that these investments typically are very risky.)

By reconfiguring cash flows associated with underlying assets, asset-backed securities can be created that isolate, enhance, or dilute one or more credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, with mortgage-backed securities, a higher yield may be provided to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Users find certain high-risk investments attractive because they can purchase the most desirable risks and rewards or synthetically create a security with the desired risk and reward characteristics.

The increased volatility of interest rates, foreign-exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products. The intent is to meet the needs of users attempting to hedge or alter the related risks.

Accounting. Accounting for certain types of high-risk investments is complex. The FASB has been carrying out a major project on the disclosure, recognition, and measurement of financial instruments, which has resulted in the issuance of FASB Statements No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), No. 115, No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), No. 105, and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text,* vol. 1, sec. B10). In addition, the AICPA Audit and Accounting Guide *Audits of Credit Unions* (the Guide) provides detailed accounting guidance related to many types of high-risk investments.

Auditing. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), requires that auditors understand the events, transactions, and practices that, in their judgment, may significantly affect the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in complex securities as they plan their audits and should—

- Assess management's expertise in monitoring, evaluating, and accounting for the securities.
- Consider whether the credit union has set clear policies and procedures for investments in high-risk securities and that there is oversight by the board of directors or supervisory committee.
- Involve specialists, when necessary, in valuing and auditing those investments. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), provides guidance to auditors who use specialists in performing audits.

As noted above, auditors should be familiar with the NCUA's *Rules and Regulations* and its Interpretive Ruling and Policy Statement (IRPS) related to investments, which are discussed further in the "Regulatory Developments" section of this Audit Risk Alert. Certain rules and regulations may affect the classification and valuation of a credit union's investments.

Investments in Derivatives. Interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months. As a result, a number of entities using these instruments have incurred significant losses. Credit unions sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to those about other transactions, an auditor's approach to achieving related audit objectives may differ because certain derivatives—futures contracts, forward contracts, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994.*

Auditors should be aware that federally chartered natural person credit unions generally are precluded by regulation from engaging in most derivative activities. However, some corporate credit unions may not be subject to such stringent restrictions and may engage in some derivative activities. Authority to engage in such activities is granted by the NCUA by waiver on a case-by-case basis. Auditors should be familiar with the NCUA's *Rules and Regulations* and IRPS 92-1, related to investments. See also the discussion of the NCUA's final rule on investment and deposit activities in the "Regulatory Developments" section of this Audit Risk Alert.

Related-Party Transactions. Certain related-party transactions continue to receive substantial public and regulatory scrutiny. Those transactions include—

- Loans to credit union officers and directors or their affiliates
- Fees or commissions paid to credit union officers and directors or their affiliates
- Other arrangements, including purchased goods or services from and contracts with officers and directors or their affiliates

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards,* vol. 1, AU sec. 334), provides guidance on procedures that should be considered by auditors to identify related-party relationships and transactions and to satisfy themselves concerning the accounting for and disclosure of transactions with related parties.

Asset Quality and Valuation Issues. Credit quality and other asset quality issues associated with business and consumer loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of credit unions. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's valuation allowances. The subjectivity of determining such amounts combined with the issues that arise in a rapidly changing economic environment, such as those discussed in the "Industry and Economic Developments" section herein, reinforce the need for the careful planning, execution, and evaluation of audit procedures in this area.

Lack of an adequate asset impairment evaluation system or failure of a credit union to document adequately the criteria and methods used to determine loan loss allowances may indicate a reportable condition in the credit union's internal control structure over financial reporting. Such a deficiency will generally increase both the extent to which judgment must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances and the likelihood that differences will result. The guidance in the Guide and in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342), should be followed in auditing loan loss allowances. Other sources of information that may be useful in auditing the loan loss allowances of credit unions include SAS No. 73, the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks,* and the AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information.*

As with credit risk, other valuation issues involve a number of subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in the valuations of loan servicing assets significantly influence the recorded values of those assets. High levels of mortgage loan prepayments in recent years have resulted in the impairment of assets such as purchased mortgage servicing receivables and interest-only securities. Subjective assumptions should be evaluated periodically in light of current economic circumstances, and impairments caused by changes in those assumptions should be recognized accordingly.

Shared Branches. Under shared-branch arrangements, several unrelated credit unions minimize the cost of doing business by sharing branch facilities and staff. The computer terminals at each branch can process deposits, withdrawals, and loan payments for all credit unions in the cooperative. Transactions are relayed to a data-processing switch where they are reformatted and posted to the subsidiary ledgers of the individual credit unions. Auditors should be aware of the risks created by the data-processing switch. The internal control structures of credit unions participating in shared-branch arrangements should include policies and procedures, such as the timely reconciliation of account balances, that ensure the proper posting and settling of the transactions processed by the shared branches. In addition, auditors should obtain an understanding of the internal control structure policies and procedures associated with the data-processing switch sufficient to plan the audit and to determine the nature, timing, and extent of procedures to be performed. To obtain this understanding, auditors should consider obtaining a service auditor's report on policies and procedures placed in operation at the data-processing switch. See the "Audit Developments" section that follows for a further discussion of service auditor's reports.

Federally chartered credit unions have no restrictions on participation in shared branches. However, state-chartered credit unions may be subject to state laws that prohibit the completion of transactions across state lines.

Non-GAAP Financial Statements. Accounting practices prescribed by federal and state credit union regulatory agencies, commonly referred to as regulatory accounting practices (RAP), frequently differ from generally accepted accounting principles (GAAP). The most common differences between GAAP and RAP (for federally chartered credit unions) are the following.

- RAP allows the maintenance of accounting records on a modified cash basis, while GAAP requires use of the accrual basis.

- RAP requires the classification of members' shares as equity rather than liabilities.
- RAP allows settlement-date, unlike trade-date basis accounting for investment securities required by GAAP.
- RAP does not require credit unions to adopt the provisions of FASB Statement No. 115 (see further discussion in the "Accounting Developments" section of this Audit Risk Alert).
- Unlike GAAP, RAP does not require the recognition of goodwill in business combinations in which either or both of the following occur:
  - The purchase price exceeds the fair value of the acquired tangible and identifiable intangible assets.
  - The fair value of liabilities assumed exceeds the fair value of tangible and identifiable intangible assets acquired.
- The allowance for loan losses for RAP purposes may be calculated using a formula approach, which may or may not result in an acceptable allowance under GAAP.

Auditors should be aware that federal credit unions that do not prepare financial statements in accordance with GAAP but instead report on an other comprehensive basis of accounting (OCBOA) are required to follow the NCUA *Accounting Manual for Credit Unions* (*Accounting Manual*), although the *Accounting Manual* has been deregulated. Auditors engaged to report on such OCBOA statements should refer to the guidance in SAS No. 62, *Special Reports* (AICPA, *Professional Standards,* vol. 1, AU sec. 623). Auditors should be aware that the OCBOA report described in SAS No. 62 may be used only if the financial statements and the report are intended solely for filing with the NCUA or other regulatory agency to whose jurisdiction the credit union is subject.

The NCUA enforces the *Accounting Manual* based on two principles: full and fair disclosure, and safety and soundness. If a credit union follows GAAP or the *Accounting Manual,* it is deemed to have met full and fair disclosure requirements for financial reporting under NCUA regulations. If the NCUA determines that a credit union has not met the full and fair disclosure requirements, the NCUA can issue a cease-and-desist order or impose civil money penalties or terminate its insurance, or both. If the NCUA determines that a failure to follow GAAP or the *Accounting Manual* has resulted in unsafe and unsound practices, the NCUA could issue a cease-and-desist order or terminate its insurance.

Audit Developments

Service Auditor's Reports. In April 1992, the AICPA's Auditing Standards Board (ASB) issued SAS No. 70, *Reports on the Processing of Transactions* *by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), which provides guidance on the factors that auditors should consider if they are auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

Many credit unions use service organizations for data processing to process loan and member share transactions, investment information, automated teller machine (ATM) transactions, credit-card transactions, and mortgage loan servicing. Service organizations are also used for data-processing switches in shared-branch operations. Auditors of the financial statements of credit unions that use service organizations may need to obtain an understanding of the internal control structure policies and procedures at the service organization if those policies and procedures affect assertions in the credit unions' financial statements.

Auditors of credit unions' financial statements who are unable to obtain the report required by SAS No. 70 should apply procedures such as those described in paragraphs 23 through 25 of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and the procedures described in paragraphs 9 and 10 of SAS No. 70 to obtain an understanding of the relevant portions of the internal control structure at the service organization. SAS No. 70 is effective for service auditors' reports dated after March 31, 1993.

Reporting on Mortgage Banking Activities. Credit unions that sell loans to, or service loans for, investors are frequently required to submit to the investors reports from an independent auditor on related activities. The reports vary in scope and complexity. Auditors who are engaged to report on the mortgage banking activities of credit unions should be aware of the following developments.

MBA USAP. The Mortgage Bankers Association of America (MBA) will soon issue a new *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP will require an examination-level engagement in accordance with SSAE No. 3. The MBA's prior guidance, *Uniform Single Audit Program for Mortgage Bankers*, was introduced in 1965 and gained acceptance as a useful guide for engagements that addressed the servicing functions of mortgage banking companies. The related engagements have been redefined to address compliance by mortgage-servicing companies with USAP's specified minimum servicing standards. The USAP will be effective for fiscal years beginning after December 15, 1994, and thereafter, with earlier application permitted. Auditors of credit unions that are contractually required to provide reports under the existing USAP may wish to discuss early application with their clients.

Freddie Mac. The Federal Home Loan Mortgage Corporation (Freddie Mac) has issued minor clarifications to its 1993 *Compliance Reporting Guide.* The guide addresses the scope of compliance attestation engagements at credit unions that sell or service mortgage loans under Freddie Mac programs, sets forth certain procedures to be performed, and presents the required reporting formats.

The engagements required by the Freddie Mac guide involve reporting on agreed upon procedures performed in accordance with SSAE No. 3. The clarifications are effective for reports issued in conjunction with engagements in which management's assertions are as of, or for a period ending March 31, 1995, or thereafter. Freddie Mac has given copies of the guide clarifications to sellers/servicers with instructions to provide copies to auditors of the sellers'/servicers' financial statements.

Mortgage Loans Serviced by Others. The MBA's USAP and Freddie Mac's *Compliance Reporting Guide* address reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70 provides guidance on the factors auditors should consider when auditing the financial statements of entities—including credit unions—that use service organizations, such as mortgage bankers that service mortgages for credit unions. Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user credit unions' financial statements. Further, some service auditors' reports prepared in accordance with SAS No. 70 include a description and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those reports may enable an auditor of the financial statements of a user credit union to assess control risk below the maximum for relevant financial statement assertions. Auditors should consult SAS No. 70 for additional information on how to use a service auditor's report when auditing the financial statements of a user credit union.

Accounting Issues and Developments

Accounting Issues

Offsetting of Certain Repurchase and Reverse Repurchase Agreements. At its February 23, 1994, Board meeting, the FASB announced that the offsetting of certain repurchase and reverse repurchase agreements is not permitted because the agreements, as described in the following, do not satisfy the conditions for right of setoff in paragraph 5(c) of FASB Interpretation No. 39. Such repurchase and reverse repurchase agreements should be reported gross.

The Board did agree to revisit the Interpretation to create an exception to paragraph 5(c) for repurchase and reverse repurchase agreements with the same counterparty that (1) are covered by a master netting arrangement, (2) settle through the Fedwire settlement system, and (3) have the same settlement date. An exposure draft of the proposed Interpretation is expected to be issued in the fourth quarter of 1994. Until that exposure draft becomes effective, credit unions should account for repurchase and reverse repurchase agreements in accordance with FASB Interpretation No. 39.

Accounting Developments

The FASB's ongoing project on financial instruments encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to those three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described below.

Derivatives Disclosures. In October 1994, the FASB issued FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics.

More specifically, the Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105, because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading.

FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement is effective for financial instruments issued for fiscal years ending after December 15, 1995.

Income Recognition on Impaired Loans. In October 1994, the FASB issued FASB Statement No. 118, *Accounting by Creditors for Impairment of a*

Loan—Income Recognition and Disclosures, which amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text,* vol. 1, sec. I08) (see page 23), to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions of FASB Statement No. 114 that describe how creditors should report income on impaired loans.

FASB Statement No. 118 does not change the provisions in FASB Statement No. 114 that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

FASB Statement No. 118 also amends the disclosure requirements in FASB Statement No. 114 to require disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

FASB Statement No. 118 is effective concurrent with the effective date of FASB Statement No. 114, that is, for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

Contributions. A number of credit unions receive substantial contributions (for example, use of facilities and utilities, telephone services, data processing, mail services, payroll processing services, pension administration services and pension plan contributions, and other materials and supplies) from their sponsoring organizations. A number of credit unions also rely on volunteers to provide various services to their members; other credit unions are staffed exclusively by volunteers.

In June 1993, the FASB issued FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (FASB, *Current Text,* vol. 1, sec. C67), which establishes accounting standards for contributions and applies to all entities, including credit unions, that receive or make contributions. FASB Statement No. 116 generally requires that contributions received, including unconditional promises to give, be recognized as revenues in the period received at their fair values. Contributions of services should be recognized if the services received (1) create or enhance nonfinancial assets or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. FASB Statement No. 116 has some specific disclosure requirements for contributed services and the Statement is generally effective for financial statements issued for fiscal years beginning after December 15, 1994.

FASB Statement No. 116 also requires additional disclosures that apply *only* to not-for-profit organizations and provides for a delayed effective date for certain small not-for-profit organizations. Auditors should be aware that credit unions are *not* considered not-for-profit organizations for purposes of this Statement.

Auditors should consider whether contributions that require recognition in accordance with FASB Statement No. 116 are identified as such and are properly valued, recorded, and disclosed in the financial statements.

Investments in Certain Debt and Equity Securities. In May 1993, the FASB issued FASB Statement No. 115, which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities,* which was superseded by FASB Statement No. 115) and for all investments in debt securities. FASB Statement No. 115 does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 establishes the following three categories for reporting debt and marketable equity securities:

- *Held-to-maturity*—Reported at amortized cost
- *Trading*—Reported at fair value with unrealized gains and losses included in earnings
- *Available-for-sale*—Reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity

The Statement also specifies the accounting treatment for transfers among categories.

Paragraph 8 of the Statement indicates that certain changes in circumstance may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. For example, there may be evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, there may be other events that are isolated, nonrecurring, and unusual for the reporting enterprise and that could not have been reasonably anticipated. These, too, may cause an entity to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. However, such sales and transfers of held-to-maturity securities are expected to be rare.

FASB Statement No. 115 stipulates that an entity shall not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if a credit union anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the following:

- Security's prepayment risk
- Needs for liquidity
- Availability of and the yield on alternative investments
- Funding sources and terms
- Foreign-currency risk

FASB Statement No. 115 also requires credit unions to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

FASB Statement No. 115 is effective for fiscal years beginning after December 15, 1993. It specifically prohibits the retroactive restatement of prior financial statements. Generally, FASB Statement No. 115 should be initially applied as of the beginning of a credit union's fiscal year (such as January 1, 1994). At that date, investments in debt and equity securities should be classified based on the credit union's current intent. Entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

Auditors should be aware that credit union investments in non-negotiable certificates of deposit (CDs) in banks or shares in corporate credit unions generally are not subject to the provisions of FASB Statement No. 115 because they are debt instruments that do not meet the definition of a security in that Statement.

Mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* [FASB, *Current Text*, vol. 2, sec. Mo4]) are classified as trading securities.

Over the past months, the FASB's Emerging Issues Task Force (EITF) has discussed a number of issues relating to the implementation of FASB Statement No. 115. Matters discussed included those described below.

At the November 1993 meeting of the EITF, the FASB staff announced the conditions under which institutions regulated by the Federal Financial Institutions Examination Council (FFIEC) cannot classify nonhigh-risk CMOs, as defined for credit unions by regulation (including mortgage-backed securities), as held-to-maturity (reported at amortized cost). They may not if regulators might require their divestiture under more adverse future market conditions, *unless* the change in rates necessary to trigger high-risk treatment is so large as to be considered remote. In July 1994, the FASB staff announced that financial institutions are not subject to the guidance in the November announcement if their chief executive officers receive an FFIEC memo that states the following: "The mere existence of examiners' divestiture authority for high-risk mortgage securities should not preclude an institution from concluding it has the intent and ability to hold to maturity those securities that were nonhigh-risk when acquired." However, the AICPA understands that, because it is likely that the NCUA would require the divestiture of such securities, credit unions will not be receiving such letters, and are, therefore, subject to the guidance in the November announcement.

In EITF Issue No. 94-4, *Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity,* the EITF discussed whether those instruments may be classified as held-to-maturity under FASB Statement No. 115. The EITF did not reach a consensus on this issue. A majority of EITF members observed that it would be rare for mortgage-backed interest-only strips to meet the criteria of FASB Statement No. 115 to be classified as held-to-maturity; the risk and volatility of mortgage-backed interest-only strips make active management more likely. Consequently, it would be rare for an entity to possess the positive intent to hold those securities to maturity. However, because federally chartered credit unions may only hold mortgage-backed interest-only securities to reduce interest-rate risk, they may be able to demonstrate a positive intent to hold those securities to maturity.

In April 1994, the FASB issued FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring* (FASB, *Current Text,* vol. 1, sec. I80). It clarifies that FASB Statement No. 115 would be applicable to the accounting by the creditor for a loan that was restructured in a troubled debt restructuring that involved a modification of terms, if the loan meets the Statement's definition of a security. The provisions of Technical Bulletin No. 94-1 are effective for financial statements issued after April 30, 1994.

If auditors have been engaged to report on financial statements prepared on an other comprehensive basis of accounting, the credit union may not be subject to the provisions of FASB Statement No. 115. In July 1993, the NCUA issued Accounting Bulletin No. 93-1, which amends the *Accounting Manual* to allow federally chartered credit unions that follow RAP the *option* of adopting FASB Statement No. 115 to account for their securities portfolios. Accounting Bulletin No. 93-1 states that "Fair value measurement [FASB Statement No. 115] and disclosure [FASB Statement No. 107] should be included on your financial statements of condition as you and your independent accounting firm agree. For those credit unions who do not seek an opinion on their financial statements, accounting for debt and equity securities may continue under existing accounting rules with *investment securities* being carried at amortized cost based on a credit union's intent and ability to hold the investments for the foreseeable future."

Auditors should be aware of some of the issues that are likely to arise if the Statement is applied. Auditing financial statements involving the classification of investments in certain debt and equity securities pursuant to FASB Statement No. 115 may involve a high degree of judgment about matters such as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a credit union to hold securities to maturity, particularly if going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing a credit union's ability to hold securities to maturity

Impairment of a Loan. In May 1993, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text,* vol. 1, sec. I08), was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment (for example, credit-card, residential mortgage, and consumer installment loans), loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

The Statement amends FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text,* vol. 1, sec. C59), to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables, in assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text,* vol. 1, sec. D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions. Auditors should be aware that this Statement may have limited application to credit unions that do not engage in business lending.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

A number of credit unions may adopt the provisions of the Statement prior to its effective date. Auditors should carefully consider the implications on audit risk of applying the Statement's provisions.

Consensus Decisions of the FASB's Emerging Issues Task Force. The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to credit unions.

In EITF Issue No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* the EITF reached a consensus that FASB Statement No. 115 changes the measure of impairment of collateralized mortgage obligation instruments or mortgage-backed interest-only certificates from undiscounted cash flows to fair value. The EITF also reached a consensus that if the present value of estimated future cash flows discounted at a risk-free rate is less than the amortized cost basis of the instrument, an impairment loss should be recognized. The EITF also reached a consensus that the amortized cost basis of those instruments that are determined to have an other-than-temporary impairment loss at the time of the initial adoption of FASB Statement No. 115 should be written down to fair value.

In EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions,* the EITF reached a consensus that credit-card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FASB, *Current Text,* vol. 1, sec. L20), and EITF Issue No. 92-5, *Amortiza-*

tion *Period for Net Deferred Credit Card Origination Costs.* Issue No. 94-4 was addressed previously in the discussion of the FASB's financial instruments project in the "Accounting Developments" section of this Audit Risk Alert.

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This Audit Risk Alert replaces *Credit Union Industry Developments—1993.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994* and *Compilation and Review Alert—1994,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141 (audit) or 060668 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.